

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 02-0021

**State Gross Retail Tax
For Tax Years 1999 through 2001**

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ISSUES

I. State Gross Retail Tax—Manufacturing Exemption

Authority: IC 6-2.5-2-1; IC 6-2.5-5-3(b)
45 IAC 2.2-5-8; 45 IAC 2.2-5-12(a)

Taxpayer protests the Department's determination that certain items of equipment did not qualify for the manufacturing exemption from sales tax because they lacked an essential and integral relationship with the taxpayer's manufacturing process.

II. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d)
45 IAC 15-11-2

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is a manufacturer of dies and molds. At issue are the Department's proposed assessments of sales and use tax on taxpayer's equipment. Additional facts are discussed below.

I. State Gross Retail Tax—Manufacturing Exemption

DISCUSSION

Taxpayer protests the Department's determination that certain items of equipment do not qualify for exemption from sales tax, under the manufacturing exemption set forth in 45 IAC 2.2-5-8, because the equipment does not have an essential and integral relationship with taxpayer's manufacturing process. These items include an air dryer and a 3D scanning machine.

Pursuant to IC 6-2.5-2-1, a sales tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Under IC 6-2.5-5-3(b), 45 IAC 2.2-5-12(a), an exemption from the state gross retail tax is provided for transactions involving manufacturing machinery, tools, and equipment if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added). 45 IAC 2.2-5-8(c) defines "direct use" as use having an immediate effect on the article being produced. Property has such an immediate effect if it is an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-8(g).

AIR DRYER

Taxpayer argues that its air dryer is exempt from the state's retail tax because it is an item of equipment having a direct and immediate effect on the production of taxpayer's mold and die products. According to taxpayer, many of its production machines (*e.g.*, airlift tables, air clutches, air brakes, air logic controls/valves, and air clamps) are operated by an air compressor system that requires clean and dry air to operate. Specifically, the air dryer acts as a filter that filters condensation out of the system and prevents moisture from penetrating the manufacturing lines. Although it is not attached directly to the air compressor, the air dryer works with the air compressor. Should water penetrate the manufacturing lines, rust would be created and the manufacturing process would be seriously, adversely affected.

Here, taxpayer has demonstrated that many of the machines used within the production process are operated by an interconnected production process comprised of an air compressor and an air dryer. The most closely analogous regulatory example is found at 45 IAC 2.2-5-8(g)(3) which states that:

The manufacture of certain extruded rubber products uses an interconnected production process of an air compressor, and air dryer, and injection molding machines which work together to force rubber through dies in order to form the desired shapes. The component parts of the production process are exempt since the production process has an immediate effect upon the article being produced.

3D SCANNING MACHINE

Taxpayer also argues that the purchase of its 3D scanning machine is exempt from the state's gross retail tax. Taxpayer maintains that it uses the machine within the production process.

Taxpayer's scanning machine is a PC-based system used primarily for "reverse engineering". Taxpayer's customers routinely send to taxpayer dies and molds that are in need of repair, replacement blocks, or engineering changes. Typically, taxpayer receives the dies and molds without computer aided design (CAD) data, and without the tool drawings with which they were originally built. Taxpayer's scanning machine is therefore used to measure the size of the work piece, any hole locations, and the 3-D contoured surfaces.

As the scanning machine scans the surface of the work piece, the information is sent to a computer (attached to the 3D scanning machine) and eventually recorded on a disc. The information recorded on the disc is then reprogrammed (using computer aided manufacturing (CAM)) into a language that taxpayer's vertical machining center (VMC) understands. The VMC is the machine that cuts the metal into the specific die or mold.

Once the information has been reprogrammed, the machinist removes the disc from the scanning machine's computer and places it into the VMC's operating system (*i.e.*, the computer numerical control or CNC). The operating system feeds the information recorded on the disc to the VMC; and, the VMC begins to produce the die or mold. Once the new piece is completed, taxpayer uses the 3D scanning machine to re-scan the piece and verify that the shape and size are correct. According to taxpayer, a piece cannot be produced without first using the 3D scanning machine to determine the surface data of the piece.

The Department's regulations at 45 IAC 2.2-5-8(g)(6) state that "[c]omputers which are interconnected with and control other production machinery or are used to make tapes which control computerized production machinery are exempt from tax." However, 45 IAC 2.2-5-8(g)(7) states that "[c]omputers which produce designs which are not sold as products are not exempt." Here, taxpayer's scanning machine is a PC-based system used to capture data regarding the work pieces taxpayer is hired to produce. The data collected by the scanning machine is recorded on a disc. The recorded information is then transferred to a VMC which machines the particular work piece desired. The evidence of file establishes that the scanning machine performs a computer aided design function; and, the designs captured by the machine are not sold as products. As such, taxpayer's scanning machine is not exempt from tax.

FINDING

Taxpayer's protest regarding the retail tax exemption of the air dryer is sustained; however, taxpayer's protest regarding the retail tax exemption of the 3D scanning machine is denied.

II. Tax Administration— Abatement of Penalty

DISCUSSION

Taxpayer protests the imposition of a ten percent (10%) negligence penalty.

IC 6-8.1-10-2.1(d) states that if a person subject to the negligence penalty imposed under said section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. 45 IAC 15-11-2 defines negligence as the failure to use reasonable care, caution or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or Department regulations.

In order to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. 45 IAC 15-11-2. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed" 45 IAC 15-11-2(c). In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits. *Id.*

In the instant case, the Department finds that taxpayer has failed to established "reasonable cause" sufficient to warrant abating the ten percent negligence penalty.

FINDING

Taxpayer's protest is respectfully denied.

HLS/JM/MR – 020227